

SEC Regulatory Challenges Facing Smaller Public Companies

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Market Forces Impact Smaller Public Companies

- The collapse of the underwriting markets since the 2000 .com implosion has had a disproportionate effect on smaller public companies
 - Relative lack of market liquidity
 - Dearth of analyst coverage
 - Less institutional support
 - Offering costs are generally fixed
- Current focus on venture-backed private companies is great, but what about companies that are already public?
- Much bigger than the VC market

Significant Market

- According to Sagient Research Systems, \$37.6B was raised in 1,140 PIPE and RD transactions in 2010 v. \$22B in total VC investment per NVCA 2010 yearbook
- 597 transactions for issuers with a market cap of < \$50MM
- 892 transaction for issuers with a market cap of < \$150MM
- 42 underwritten deals for issuers with a market cap < \$75MM in 2010 raising over \$570MM
- 238 underwritten deals for issuers with a market cap < \$500MM in 2010 raising over \$10B

Market Dynamics Have Required Improvisation

- Smaller public companies have had to scramble for capital
 - PIPEs
 - Registered direct offerings
 - Reverse mergers
 - “APOs”
- Since 2008 investors have required increased liquidity
 - RDs and other registered offerings have increased
 - 291 RDs in 2010 v. 70 in 2001

Regulatory Environment Penalizes Small Issuers

- “Baby Shelf” Rule
 - Instruction I.B.6. to Form S-3
 - If public float < \$75MM limited to 1/3 public float in 12 month period
 - Must be “listed” to make use
 - Warrants treated as if underlying securities sold
- Availability should be expanded
 - No reason to penalize unlisted companies
 - Unlisted smaller public companies have the fewest options
 - Listing has become less relevant in today’s electronic marketplace
 - No evidence of a disparity in quality of available information
 - 1/3 public float requirement should be increased or eliminated
 - Similar limitation in original Rule 415 was removed
 - No rational relationship to purpose of the offering
 - Investors look to fund a business plan, not at percentage of issuer being sold
 - Cap is frequently difficult to calculate
 - Lack of S-3 availability has resulted in higher costs and more complex structures
 - Issuers forced to use S-1 at much higher cost and less certainty
 - PIPEs at unfavorable pricing due to lack of liquidity
 - Heavily structured private offerings

Regulatory Environment Penalizes Smaller Issuers

- Staff's Rule 415 Interpretation
 - Concern that offering is actually on behalf of issuer and not selling stockholders
 - Arbitrary 1/3 “screening” test
 - If “veiled” primary, then issuer must either qualify to use S-3 for a primary offering or offering must be made at a fixed price
 - Investors treated as “underwriters”

Regulatory Environment Penalizes Smaller Issuers

- Staff 415 Position has created enormous market uncertainty
 - Does it apply only to “toxic” deals or all offerings?
 - Has the Staff moderated its position or not?
 - How will a Staff 415 comment be resolved?
 - How will a Staff 415 comment affect timing?

Regulatory Environment Penalizes Smaller Issuers

- Problems with Staff 415 Interpretation
 - Focuses primarily on the percentage of shares registered
 - Ignores other relevant factors in the Staff's own interpretive guidance
 - Amount of securities the least relevant factor in determining whether a "distribution" is occurring
 - Ignores reality that trading volume may prevent sale for many years
 - Ignores investment representations in purchase documents
 - Reintroduces presumptive underwriter issues
 - "Cut back" remedy makes no sense
 - Limits the ability of investors to fund business plans
 - Potentially guts the Staff's PIPE Interpretation
 - Does nothing to "protect" investors

Regulatory Environment Penalizes Smaller Issuers

- Form S-1 prohibits forward incorporation by reference
 - Unfair burden on smaller public companies
 - Companies with more than \$75MM public float can use S-3
 - “Baby Shelf” limitations force issuers to use S-1 to avoid limits
 - No regulatory justification
 - EDGAR information available to everyone
 - No difference in availability of information
 - All incorporated documents available for SEC review and comment
 - Creates significant problems for smaller public issuers
 - Need for regular post-effective amendments
 - Quarterly supplements
 - Imposes artificial limitations on when offerings can take place
 - Significantly increases offering costs

FINRA Not Helping

- Proposed FINRA Rule 5123
 - Would impose certain disclosure obligations on FINRA members participating in private placements
 - Anticipated use of proceeds, offering expenses and compensation
 - Disclosures must be provided to investors pre-sale and filed with FINRA post-offering
 - Applies to all private placements, subject to limited exceptions
 - No exemption for offerings solely to “accredited investors”
 - Arguably pre-empted by Regulation D
 - Will significantly increase offering costs and increase potential liability to FINRA members with no demonstrable benefit to investors
 - Original proposal was much worse

One More Thing....

- Repeal Section 16(b) of the Exchange Act
 - Rationale for 16(b) no longer applies
 - Robust body of case law on Rule 10b-5 liability
 - Private right of action for 10b-5 violations
 - Schedule 13D, Forms 3, 4 and 5 assure timely disclosure of trading by insiders
 - Regulation FD provides additional investor protection
 - 16(b) has disproportionate impact on smaller public companies
 - Investors much more likely to own more than 10%
 - New investors refuse to cross 10%
 - Existing investors less likely to re-invest
 - Limits ability of smaller public companies to raise capital

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